



CHAPTER 1

REGISTRAR'S REVIEW

most important issue reviewed is the liquidity crisis among small and mid-sized banks and subsequent consolidation

Among the issues of interest discussed in this review are the lessons arising from the highly publicised failure of international corporations such as Enron and Worldcom. The most important issue reviewed in this chapter, however, is the liquidity crisis among small and mid-sized banks and subsequent consolidation in the South African banking sector during 2002, together with the lessons and the policy framework for dealing with banks in distress arising therefrom. Other issues reviewed include the level of concentration in the South African banking system, the ongoing debate on the financial architecture and the corporate-governance review of South Africa's five largest banking institutions instituted in the wake of the above-mentioned corporate failures and recent bank failures in this country.

OVERVIEW OF SOUTH AFRICAN BANKING SYSTEM

fairly turbulent first half year

As discussed later in this chapter, there was considerable consolidation in the South African banking sector during 2002. After a fairly turbulent first half year, which saw the demise of a number of small and medium-sized banks, stability returned. South African banks remained well capitalised, and the average risk-weighted capital-adequacy ratio for the sector increased to 12,6 per cent at the end of December 2002, compared to 11,4 per cent in 2001.

concentration in the South African banking sector increased noticeably

Growth in the total balance sheet moderated during 2002, mainly as a result of a moderation in the growth of total loans and advances. By the end of December 2002, the total funds of banks – comprising capital, reserves, deposits and loans – had increased by 4,8 per cent (measured over a period of twelve months), to a level of R1 100,8 billion. Concentration in the South African banking sector increased noticeably during 2002, and the four biggest four banks now represent about 80 per cent of the total banking sector. Prior to the merger of Nedcor Bank Limited and BoE Bank Limited, discussed later in this chapter, the four biggest banks represented 74,2 per cent of total banking-sector assets. The participation of foreign banks in the local banking industry decreased for the first time in six years, from 7,7 per cent in 2001 to about 6,9 per cent of the total banking-sector assets by the end of December 2002.

participation of foreign banks decreased

marginal shift to longer term deposits

Total non-bank deposits increased by 12,5 per cent (measured over a 12-month period) in December 2002, from 9,7 per cent in December 2001. The composition of non-bank deposits showed a marginal shift from short-term and medium-term deposits to longer term deposits.

return on equity and return on assets deteriorated

Both the return on equity and the return on assets of the total banking sector deteriorated during the year under review. By the end of December 2002, the average return on equity was 5,6 per cent, down from 9 per cent in December 2001, and the return on assets also decreased, from 0,8 per cent in December 2001 to 0,5 per cent in December 2002. The interest margin, on the other hand, increased to 3,8 per cent in December 2002, from 3,2 per cent in 2001. The efficiency of the banking sector also deteriorated, from 64,1 per cent in 2001 to 67 per cent in 2002.

efficiency also deteriorated

adequate levels of liquidity

South African banks maintained adequate levels of liquidity despite liquidity strains experienced by the system during the first half of 2002, as discussed later in this chapter. In December 2002, banks' liquid assets (calculated on the basis of total liabilities less capital

and reserves) amounted to 118,1 per cent of liquid assets required to be held, compared to a level of 113,5 per cent in December 2001.

total gross overdues
decreased

Total gross overdues of the banking sector decreased by R61,4 million compared to the previous year, to a level of R26,1 billion at the end of December 2002. Provisioning by banks against these non-performing loans was adequate, even when benchmarked against international requirements.

LESSONS ARISING FROM RECENT HIGH-PROFILE CORPORATE FAILURES

destructive element in such
failures

In the final analysis, the high-profile failure of enterprises such as Enron, Worldcom and others is proof that the market-based capitalist system ultimately rids itself of inefficient and ineffective economic participants that are not soundly structured and operated. When such failures occur, resources that were applied suboptimally are freed and can then be applied more optimally. In this way, productivity gains are made, to the benefit of the greater good. The destructive element in such failures is not the failure itself, but the criminal activity, such as fraud, theft and deliberate misrepresentation, that has occurred.

objective of regulatory and
supervisory authorities

Since we do not live in a perfect world, it is natural to expect that some economic participants will fail. The objective of regulatory and supervisory authorities can never be to avoid the failure of economic participants, and, in a sound system, there will be failures. If it were the objective to ensure no failures, supervision and regulation would have to be so intense as to stifle activity, and the cost of such an approach would simply be too high. Instead, the objective is to strive for an optimal balance between, on the one hand, the cost of controls and intervention in order to address market failures and, on the other hand, the anticipated benefits of regulation and supervision.

some conclusions

The highly publicised failures in the United States of America and elsewhere during the past number of years have again proved that most failures of previously successful economic participants are due to a range of reasons that are well known, reasonably easily identifiable and reasonably easily preventable. The importance of the failure of corporate enterprises such as Enron and Worldcom lies in the fact that these failures have already changed and are continuing to change the behaviour of stakeholders for the better. For example, energy traders' cost of equity capital and borrowed capital has increased, and employees are demanding improved security for their pension-fund investments. Another long-term effect will be an improvement in the quality of corporate governance, independent auditing, independent ratings and oversight by the authorities.

Some of the conclusions that can be drawn from these failures are discussed below.

Risk versus reward

the following fundamental
issues are not adequately
addressed

The positioning of an enterprise along the risk-versus-reward continuum and proper analysis thereof hold critical implications for, amongst others, investors and providers of funds, management of enterprises, internal and external auditors, rating agencies and regulators. Unfortunately, however, it has become clear that, generally, there is a lack of ability to perform such analyses and that even when such analyses take place, they tend to be clouded by a lack of independence. Typically, the following fundamental issues are not adequately addressed or taken into account:

- ▲ The nature and sustainability of competitive advantages, and the consequent ability to add economic value by a consistent achievement of returns in excess of an enterprise's cost of capital.

- ▲ The quality of an enterprise's earnings, as indicated by the nature, sources and consistency of these earnings. Particularly significant is the extent of the correlation between earnings and cash flows.
- ▲ The size and consistency of an enterprise's cash flows.
- ▲ The level of stress and risk, as indicated by operational and financial leverage.
- ▲ The nature of an enterprise's corporate culture, that is, the balance between the own interests of personnel and the interest of the enterprise.
- ▲ The gap between investors' expectations, as reflected in the market rating of an enterprise, and the underlying realities pertaining to the enterprise, such as the position of the enterprise in the industry within which it operates and the nature of the economic cycle generally, as well as the particular industry's position in that cycle.

Corporate governance

Corporate governance may be described a system of checks and balances that have as their objective to improve the quality of decision-making. The quality of decision-making, in its turn, determines the quality of the outcome.

lack of appropriate checks and balances

A gross lack of appropriate checks and balances is evident in most corporate failures. Some common weaknesses include an insufficient number of independent directors, compliant and unquestioning boards and board committees, a lack of appropriate division of duties and responsibilities and a lack of independence.

Accounting

Accounting may be described as a system that aims to provide relevant and reliable information on which decisions can be based.

areas causing concern

In many areas, accountants have not yet been able to agree on and produce sound and generally accepted solutions to complex issues. This has resulted in even greater confusion among non-accountants. Among the areas causing concern are staff incentives, related-party transactions, non-consolidated special-purpose vehicles, intangibles, revenue recognition, off-balance-sheet items and financial instruments.

External auditors

role of the external auditor

The role of the external auditor of an enterprise is to provide assurance on the relevance and reliability of the information on which the general public base their decisions. Unfortunately, in a number of corporate failures, the external auditors appear to have failed miserably. A critical failing appears to have been various dimensions of a lack of independence.

Conclusions

Not all problems that led to recent high-profile corporate failures are listed above. Those that are listed, however, include some of the most important issues now being addressed by various authorities and professional bodies worldwide.

market discipline is working effectively

The fact that these failures appear to be pervasive does not point to a fundamental failure of the market-based system. Instead, it indicates that market discipline is working effectively by ridding the market of suboptimal enterprises well before the authorities realise

that there are problems. Obviously, criminal activity cannot be tolerated and must be rooted out.

What cannot be provided is absolute assurance that such failures will not occur again. Even if it were possible to provide such assurance, the cost thereof would be prohibitive, and innovation and initiative would be destroyed.

reminder of the difference
between banks and industrial
enterprises

The failures also serve as a stark reminder of the difference between banks and industrial enterprises. Had a bank with the market capitalisation or net asset value of an enterprise such as Enron or Worldcom defaulted, the ramifications for the economy would have been far more serious. There would have been a high probability of contagion within the banking sector, with disastrous systemic implications for the economy as a whole.

CONSOLIDATION IN BANKING SECTOR

As reported in previous annual reports, small banks in South Africa were faced with liquidity pressures in the latter part of 1999. Subsequently, there was a gradual loss of depositor confidence in small to mid-sized participants in the South African banking sector.

trend arose from a number
of factors

This trend arose from a number of factors. These included the South-East Asian financial crisis of 1997 and the concomitant banking crisis, the Russian financial crisis of 1998 and the related banking gridlock, and the imposition of curatorship over a relatively small bank, FBC Fidelity Bank Limited (FBC), in the last quarter of 1999. The trend reached its zenith upon the imposition of curatorship over Saambou Bank Limited (Saambou) in February 2002 and the subsequent takeover of BOE Bank Limited (BOE) by Nedbank Limited (then named Nedcor Bank Limited), which arose from BOE's liquidity strain. In view of the extensive media coverage that the Saambou and BOE cases received during the past year, their demise is discussed in more detail below.

Between 1997 and 2002, a number of other banks (such as Ons Eerste Volksbank, The Business Bank Limited, Real Africa Durolink Investment Bank Limited and Unibank Limited) were taken over, or exited the banking sector (such as Southern Bank of Africa Limited and TA Bank of South Africa Limited), whereas others (such as New Republic Bank Limited and Regal Treasury Private Bank Limited) were placed under curatorship. In consequence of the Nedbank/BOE transaction, Brait Merchant Bank Limited and Corpcapital Bank Limited requested that their registration as banks be withdrawn. From the beginning of 2002 to the end of March 2003, some 22 banks exited the South African banking system.

Demise of Saambou and BOE

As indicated above, the problems in the South African small-bank sector started with the imposition of curatorship over FBC. This step, together with uncertainty about the potential impact of the then topical year 2000 computer issue on the banking system, caused relative unease in the South African market and a loss of depositor confidence in some smaller banks.

The demise of FBC also sparked a confidence crisis in its largest shareholder of reference, Fedsure Limited (Fedsure), a life-insurance company. Since Fedsure held approximately 46 per cent of the shares in Saambou, the lack of confidence in Fedsure extended to Saambou.

apparently lost sight of the
bank's core business

During 2000, the management of Saambou apparently lost sight of the bank's core business. In essence, Saambou's management engaged in various business schemes with a view to finding a new partner for the bank, whilst also diversifying its business activities.

steady withdrawal of deposits

The first indication of something amiss was the sale of Saambou shares by two of the bank's executive directors. Press coverage triggered media speculation that the share sales were due to management knowing that the bank had been underperforming. Saambou's subsequent issue of a profit warning exacerbated the situation. In its announcement, Saambou ascribed the bank's poor performance to losses suffered in its microfinance-business activities. This was followed by the JSE Securities Exchange South Africa (JSE) announcing that it would institute an insider-trader investigation into the two directors' share-sale transactions. Saambou was subsequently faced with a steady withdrawal of deposits.

loss of confidence in micro-finance

Adding fuel to the fire, Unibank Limited (Unibank) announced at the beginning of 2002 that it had lost its entire capital base as a result of losses sustained in its microfinance business. Because of the consequent loss of confidence in one of Saambou's product lines, that is, microfinance, Saambou's share price deteriorated, and the bank lost further deposits. The Bank Supervision Department then requested one of the big four auditing firms to conduct a solvency due-diligence audit of Saambou. The auditors expressed the opinion that the bank was solvent. The rating agency Fitch, however, had placed Saambou on a negative rate watch, pending an evaluation of Saambou's action plans to overcome its liquidity problems.

All these events placed Saambou's share price under extreme pressure. Wholesale depositors started withdrawing their deposits at an increasing tempo, leaving the bank with retail deposits, most of which were subject to term conditions. This was a manifestation of the asymmetry of information argument – that those who are best informed act immediately, to the detriment of the uninformed.

contagion would set in

Since Saambou was the seventh largest South African bank and had both a large retail deposit base and a well-established branch network, the regulator regarded the bank as systemically significant. In other words, the regulator was of the opinion that the entire banking system would be placed in jeopardy if Saambou were unable to settle its transactions – that contagion would set in – and that failure of the bank would greatly damage confidence in the banking system.

contagion moved rapidly up the ladder

As the regulator had feared, contagion set in after the imposition of curatorship over Saambou. Not only did most of the banks smaller than Saambou experience large withdrawals of deposits, but contagion moved rapidly up the ladder as well. As confidence in these banks dissipated and their deposit base was consequently eroded, the net interest income of these banks declined. A general decline in the business cycle led to a concomitant slowdown in the level of business activity. Therefore, other sources of income for these banks, which could no longer attract new and longer term funding, came under pressure and could not compensate for these banks' loss in net interest income. It became increasingly difficult for these banks to maintain their profitability, also because of the need to maintain higher levels of liquidity. This, in turn, impaired the profitability of these banks even further, until most of them started making losses.

liquidity assistance to some small banks

Some of these small banks lost up to 40 per cent of their deposit base, resulting in a severe decrease in their share price on the JSE. The South African Reserve Bank provided liquidity assistance to some of these small banks, in the belief that the liquidity crisis was short term and would correct itself once normality returned to the market and depositors regained confidence. Unfortunately, this did not happen, and the small banks in question had to exit the banking system, albeit without any loss to the *fiscus* or depositors.

Of extreme concern to the regulator was that contagion also set in higher up the banking ladder. This significantly affected the sixth largest bank, BOE, which was also regarded as systemically significant. This unfortunate turn of events was due largely to a market per-

ception that the authorities lacked clarity and certainty in dealing with banks in distress, suggesting that the market was testing where the proverbial line in the sand would be drawn.

drastic action by the authorities stopped the withdrawals

BOE suffered rapid, large withdrawals by its wholesale depositors and approached the Reserve Bank for liquidity assistance. Since this did not stem the tide of withdrawals, the National Treasury issued a guarantee to all depositors that their withdrawals would be funded by the *fiscus*. This drastic action by the authorities stopped the withdrawals from BOE and provided the necessary signal to the market that the authorities were serious about maintaining the stability of the banking sector. As indicated above, Nedbank then acquired BOE and took over the responsibility of funding the assets, allowing the National Treasury to withdraw its guarantee, since it was no longer necessary.

Important lessons

many reasons for failures

There are many reasons for failures and suboptimal outcomes in the resolution of banking crises. These include external factors, weak corporate governance, weak risk management and fraud. Some important lessons, however, can be drawn from the unfortunate sequence of events outlined above.

banks are built on public confidence

As has been shown above, banks are built on public confidence. The general public has a special relationship with banks, because banks act as the repositories of the public's surplus resources and savings, which have to be readily available. For that reason and because of the intertwined exposures of banks to one another, a loss of confidence in one bank can very rapidly lead to contagion – that is, a loss confidence in other banks, smaller and bigger, and, ultimately, in the whole banking sector - with potentially disastrous consequences to the economy. Contagion risk should therefore never be underestimated.

special nature of banks

Because of the special nature of banks, all key players, both within and outside the banking sector, should not underestimate the gravity of their respective responsibilities with regard to the banking sector. Important external players include external auditors and rating agencies, as evidenced by the scrutiny under which the external auditors of failed enterprises are being placed worldwide and the negative effect of adverse ratings on the small-bank sector at the time of the Saambou crisis.

crucial that a systemically significant bank in distress be identified as such

It is therefore crucial that a systemically significant bank in distress be identified as such by all authorities that exercise responsibility in the resolution of a crisis or bank in distress. Of equal importance is that the resolution of a bank in distress must take into account the contagion effect. The authorities also have to be mindful of the fact that all their actions, combined and separately, constitute signals to the market and that greater problems may result if a bank in distress is not handled in a manner that provides certainty.

confidence of the general public

Given the nature and level of sophistication of the banking sector in South Africa, an institution aiming to conduct traditional banking business - namely, to take deposits and make advances - can succeed only if it has gained the confidence of the general public. Alternatively, such a bank has to be niche player to enable it to gear its balance sheet. As is well known, banks' margins (that is, the difference between the interest income earned on credit granted and the interest expense incurred in respect of deposits received) are tight as a result of the high level of competition that prevails in the traditional banking market. Therefore, only banks that are able to optimise their level of gearing - that is, the ratio of deposit funding to own capital - can maintain their profitability.

Other important issues

usually liquidity problems
well before insolvency

Some other issues of importance should also be noted. It is somewhat unusual for a bank to become insolvent, since loss of confidence in a bank usually leads to liquidity problems well before the point of insolvency. Often, this culminates in default, in that the particular institution can no longer meet its deposit withdrawals, because of the typical maturity mismatch between banking assets, which tend to be long term, and banking liabilities, generally short term. Once a bank is no longer a going concern - for example, as a result of the imposition of curatorship - the quality of the bank's assets often deteriorates to such an extent that insolvency rapidly becomes a reality.

negative effects of the
resultant decrease in com-
petition

The loss of confidence in small and mid-size banks outlined above means that the breeding ground that would normally yield the leaders in innovation and the big banks of tomorrow has been decimated. The negative effects of the resultant decrease in competition will include less optimal allocation of resources, less choice for consumers and less attractive offerings to consumers. During the past year, these negative effects became clearly visible in the widening of the South African banking sector's net interest margin.

Corrective measures cannot, however, be imposed by authoritarian decree. The right conditions need to be established and maintained to foster a small and mid-size banking sector. This is a long-term initiative, fraught with great complexity. The challenge is to create an enabling environment.

market-based economy

South Africa has a market-based economy. The implications thereof for banks in South Africa can be summarised as follows. A system of free entry and free exit, subject to compliance with certain minimum standards and minimum criteria, applies in the banking sector. In other words, parties that are fit and proper, in a position to capitalise a bank at the required minimum level, wish to establish a bank for purposes of pursuing an acceptable and appropriate public good and have a viable and robust business plan have an excellent chance of being granted authorisation to establish a bank. Once registration as a bank has been granted, the management (in the widest sense of the word) of the banking institution has to ensure its survival and success. Similarly, unless there are systemic-risk considerations, a bank in distress has to find its own solutions to its problems. As explained in previous annual reports, it is not the function of regulatory and supervisory authorities to manage banks or to prevent bank failures.

management of banking
institution has to ensure its
survival and success

public confidence can
disappear in an instant

A bank's management is responsible for ensuring that the general public retains its confidence in the bank. Reputational risk, therefore, is one of the most important risks that the management of a bank has to address effectively. It takes a long time to build public confidence, but, as has been sketched above, it can disappear in an instant.

high risk associated with
entering a new market

The problems recently experienced by some banks that had entered the microlending market (for example, Saambou and Unibank) again illustrate the high risk associated with a bank entering a new market. This risk is further compounded by a high rate of growth at a stage when a full understanding of the market has not yet been achieved or when systems cannot yet cope with increasing volumes.

The events outlined above again highlight the critical importance of a sound working relationship and proper coordination between the Ministry of Finance, the central bank and the banking supervisor.

POLICY FRAMEWORK FOR DEALING WITH BANKS IN DISTRESS

As a result of the problems prevalent in the small to mid-sized banking sector during 2002, discussed extensively above, the South African Reserve Bank adopted a policy framework for dealing with banks in distress.

In the normal course of its supervisory duties, the Bank Supervision Department assesses the risk-management processes and controls instituted by banks. Therefore, the Department is often able to identify circumstances that could cause a bank to lose credibility in the market, which, in turn, could result in a loss of depositor confidence and subsequent withdrawals of deposits. Once the Department has identified a bank as being in distress, any of the scenarios discussed below may apply, depending on the circumstances.

Bank with liquidity problem

When a bank has a liquidity problem, the regulator has to assess whether settlement failure - that is, the bank no longer being able to meet its payment obligations - is imminent. Consideration is then given to granting such a bank a concession to use its statutory liquid assets and minimum cash reserves – that is, its prudential assets - to allow settlement to proceed. If the liquidity problem proves to be short term and the aforementioned concession tides the bank over the problem, and the prudential assets are restored, the regulator will condone the shortfall in prudential assets for the period of non-compliance with the statutory requirements.

If the above-mentioned concession proves not to be sufficient to stem the tide of deposit withdrawals, the bank may become insolvent. Therefore, the bank's directors are then summoned to the South African Reserve Bank and requested to devise a private-sector resolution. Options in such a private-sector resolution may include one or more of the following steps, depending on the particular circumstances:

private-sector resolution

- ▲ Injection of new share capital.
- ▲ Securitisation of assets.
- ▲ Merger with another bank.
- ▲ A new shareholder of reference taking up a large stake in the bank.
- ▲ Subordination of some deposits as secondary capital.

Invariably, the management of the bank is replaced by more competent managers at this stage.

Solvency due-diligence audit

In the meantime, the regulator will appoint an auditing firm that is not one of the external auditors of the bank in distress to perform a solvency due-diligence audit in order to establish whether the bank is still solvent. The private-sector resolution might of course restore the bank's solvency through the injection of fresh or subordinated capital.

If a solvency due-diligence audit proves the bank in distress to be solvent, the next issue that the regulator has to address is whether the bank is of systemic significance. As indicated earlier in this chapter, the regulator has to assess whether the entire banking system would be placed in jeopardy if the bank were unable to settle its transactions and whether confidence in the system as a whole would be damaged if the bank were to fail.

Bank solvent and systemically significant

If a bank in distress proves to be solvent and is considered to be systemically significant, the South African Reserve Bank, as lender of last resort, would provide liquidity assistance, in combination with one or more of the above-mentioned private-sector resolution meas-

liquidity assistance

merger with another bank

ures. If the combination of public- and private-sector assistance does not restore confidence in the bank, a merger with another bank is the only option that can be pursued. Such a merger will be effected with a well-managed bank, in the interest of a stable banking system, that is, in the interest of all banks. If the combined public/private-sector assistance is effective, however, the amount of special liquidity assistance provided will be repaid, and the bank will continue to be supervised in terms of the normal supervisory process.

Bank solvent, but not systemically significant

special short-term liquidity assistance

Should a bank in distress be found to be solvent by a solvency due-diligence audit, but not be regarded as systemically significant, the South African Reserve Bank would provide special short-term liquidity assistance, at a penal rate. Again, this would be combined with a private-sector resolution. In addition, such assistance would have a sunset clause, in terms of which the amount of assistance provided would have to be repaid by a certain date. If the short-term special liquidity assistance to a solvent, but not systemically significant, bank proves not to be adequate, a curator is appointed to freeze the bank's deposits and to start an asset-liquidation process in order to repay depositors.

Bank not solvent, but systemically significant

purchase-and-assumption transaction

If, however, a bank in distress is found not to be solvent, but is regarded as systemically significant, the fiscal authorities might enter into a purchase-and-assumption transaction. Thereby, the bank is purchased by the public authorities until it can be nursed back to health, at which stage the bank can again be privatised. This option was chosen in Sweden to salvage the banking system in the early 1990s, when 18 per cent of total unconsolidated bank loans were reported lost.

Bank neither solvent nor systemically significant

appoint a curator, or apply for liquidation

If a bank in distress is neither solvent nor systemically significant, the regulator can either approach the Minister of Finance to appoint a curator, or apply for liquidation of the bank, depending on the circumstances.

Conclusion

depends entirely on the particular circumstances

As the policy framework set out above clearly illustrates, the way in which a bank in distress is handled depends entirely on the particular circumstances. It is hoped that the policy framework will serve to provide clarity on the process in place for dealing with banks in distress, as well to prevent problems in one bank spreading to other banks. It is, however, only a framework to guide the approach taken, which has to be decided on a case-by-case basis, depending on the specific circumstances. Once again, it needs to be stressed that it is not the responsibility of the regulator and supervisor to prevent bank failures. The need for a sound relationship and proper coordination between the fiscal authorities and the regulator can also not be overemphasised.

CONCENTRATION IN THE SOUTH AFRICAN BANKING SYSTEM

Several indices may be used to measure concentration and competition in a banking system. As explained extensively in the previous annual report, the most widely used index in the literature is the Herfindahl-Hirschman Index, commonly referred to as the H-index.

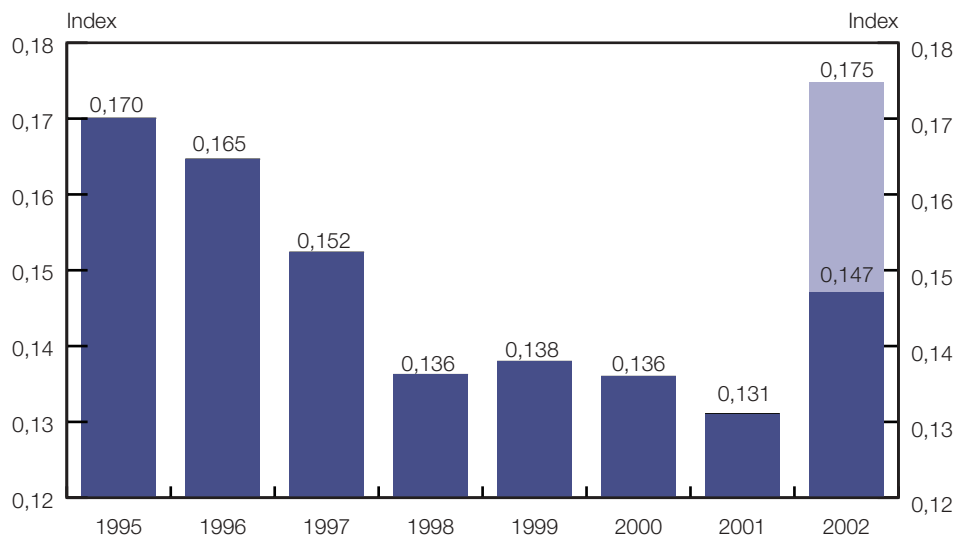
rapid consolidation

Worldwide, the ongoing consolidation of banking institutions has been one of the most notable features of the financial landscape over the past number of years. South Africa's banking system has not been immune to this trend, and there has been rapid consolidation during the past twelve months, as discussed earlier in this chapter.

direct results are greater concentration and structural changes

Two direct results of such consolidation are greater concentration in and structural changes to the banking system. During the year under review, the market share of the so-called big four banks in South Africa increased by no less than 5 percentage points, from about 69 per cent in 2001 to about 74 per cent at the end of 2002. This increase did not take into account the effect of the merger of BOE Bank Limited (BOE) with Nedcor Bank Limited (subsequently renamed Nedbank Limited) and the Nedcor restructuring process, whereby BOE, Nedcor Investment Bank Limited and Cape of Good Hope Bank Limited were consolidated into one bank, Nedbank, early in 2003. It is estimated that the effect of this merger and restructuring process will increase the market share of the big four banks to about 82 per cent.

H-index for the South African banking system (1995-2002)



rapid increase in the H-index

In South Africa, which had some 45 banking institutions at the end of the year under review, the H-index declined steadily from 0,170 in 1995 to 0,136 in 1998. From 1998 to 2001, the H-index remained stable, before deteriorating to 0,147 in 2002, as illustrated in the figure above. The rapid increase in the H-index can be attributed mainly to the liquidity crisis and subsequent consolidation in the small-bank sector discussed earlier in this chapter. When the estimated effect of the above-mentioned Nedbank-BOE merger and restructuring process is taken into account (the shaded area in the figure above), the H-index will deteriorate even further to 0,175. This represents an increase of 33,4 per cent in the H-index from 2001 to 2002.

Level of competition

level of concentration and competition is of concern

To some extent, the H-index is also an indication of the level of competition in a banking system. The rapid increase in the H-index therefore raises questions about the level of competition in the South African banking sector and the market power of banks. The more concentrated a banking system is, the more likely it is that banks will be able to raise prices for their products and services. As indicated earlier in this chapter, an expected result of greater concentration is a higher margin between the lending and deposit rates of banks. Although the four biggest retail banks have emerged even stronger from the 2002 crisis, the level of concentration and competition is of concern to the regulator.

DEBATE ON THE FINANCIAL ARCHITECTURE

In previous annual reports, the Bank Supervision Department reported extensively on the debate about whether banking supervision should be an integral part of the functions of the South African Reserve Bank.

In the 1993 annual report, it was reported that the Committee of Investigation into the Promotion of Equal Competition for Funds in Financial Markets in South Africa, chaired by Dr A S Jacobs, proposed in September 1992 that both the Registrar of Banks and the Executive Officer of the Financial Services Board (FSB) should report to an independent financial regulation policy board. Clear implementation guidelines were expected during 1993 from the committee reporting on a holistic approach for financial supervision, chaired by Mr Justice D A Melamet.

practical issues and problems first had to be resolved

As previously reported, however, the proposals of the Jacobs and Melamet Committees were not given full effect, largely because practical issues and problems first had to be resolved. Despite the establishment of the Policy Board for Financial Services and Regulation in 1993 and the subsequent implementation of a number of measures to achieve greater cooperation between the FSB and the Bank Supervision Department, the two regulators continued to function separately.

recommencement of the debate in March 1999

The recommencement of the debate in March 1999, through round-table discussions initiated by the Minister of Finance, and subsequent arguments for and against a single-regulator model were reported extensively in the previous annual report. It was also reported that the Minister of Finance commented in Parliament in mid-2001 that the Government intended establishing a single financial regulator in the near future.

banking supervision closely aligned with the Reserve Bank's other functions

In his address to the eighty-second ordinary general meeting of shareholders in August 2002, Governor Tito Mboweni expressed the view that banking supervision should remain part of the South African Reserve Bank's functions. He explained that the problems in the banking sector early in 2002, discussed earlier in this chapter, had shown that banking supervision was closely aligned with the Reserve Bank's other functions. Governor Mboweni stated, amongst other things, that these problems had shown that "a least-cost resolution of a banking crisis would always depend on a special collegial interaction between the Registrar of Banks and at least four other departments in the Bank. The policy formulation, decision-making, co-ordination and rapid execution of the many interventions that were necessary would have been almost inconceivable in a situation where the supervision of banks was not part of the Bank".

stability in the banking sector integral to the transmission of monetary policy

Governor Mboweni reiterated many of the considerations expressed in the Bank Supervision Department's 2000 and 2001 annual reports. An important consideration remained that stability in the banking sector was integral to the transmission of monetary policy, resulting in a need for the central bank to be involved in banking supervision. The Governor also reiterated one of the fundamental differences between banks and other financial institutions - namely, that banks were prone to contagion, as discussed earlier in this chapter. He further indicated that a risk-based approach to supervision, as adopted by the Bank Supervision Department in the early 1990s, was more appropriate to banks than a rules-based approach, since every case of banking distress was unique, as the policy framework for dealing with banks in distress discussed above also illustrates. The Governor reiterated, however, that close cooperation between the different regulatory authorities was essential in order to promote effective consolidated supervision of financial conglomerates.

risk-based approach to supervision more appropriate

close cooperation between regulatory authorities essential

Towards the end of the International Conference of Banking Supervisors held in Cape Town, in September 2002, and discussed in chapter 2 of this annual report, the matter of

ability to cooperate and act decisively more important than institutional arrangements

a single financial regulator was also raised. Mr William McDonough, Chairman of the Basel Committee on Banking Supervision and President and Chief Executive Officer of the Federal Reserve Bank of New York, commented that supervision by the central bank and by a separate regulator could both work, as experience in the United States of America had shown. Deputy Governor Gill Marcus reiterated a view previously expressed by, amongst others, the South African Reserve Bank that the ability to cooperate and act decisively, in a coordinated manner and in a very short time, was more important than the institutional arrangements.

CORPORATE-GOVERNANCE REVIEW

status of compliance with sound corporate-governance practices

On 15 August 2002, Deputy Governor Gill Marcus announced that the South African Reserve Bank had agreed with the five largest banking groups in South Africa to investigate, in terms of section 7 of the Banks Act, 1990, the status of compliance with sound corporate-governance practices within these banking groups. Deputy Governor Marcus emphasised that the review was a pro-active step to maintain the credibility of and foster confidence in the South African banking sector, in the wake of the recent failure of local banks, such as Regal Treasury Private Bank Limited and Saambou Bank Limited, and highly publicised international corporate failures, such as those of Enron and Worldcom. The investigation was led by Advocate John Myburgh SC, assisted by three members of the Bank Supervision Department.

purpose of the investigation

The purpose of the investigation was to:

- ▲ Investigate compliance with corporate-governance best practices as laid down by the Banks Act, the Regulations thereto and the March 2002 recommendations of the King Committee on Corporate Governance.
- ▲ Establish the extent to which, firstly, an adequate and effective corporate-governance process had been established and maintained within the controlling company, the bank and its subsidiaries and, secondly, the board of directors monitored the overall effectiveness of the corporate-governance process.

areas investigated

The scope of the review was to establish, as well as describe and express an opinion on, the adequacy of a wide range of areas, although the investigation was not limited thereto. In particular, the areas investigated included the following:

Executive and non-executive management

- ▲ Structure, composition, role and functions of the board of directors.
- ▲ Independence of directors.
- ▲ Director selection, career path and development.
- ▲ Role of the chairman of the board of directors.
- ▲ Role and functions of the risk-management committee, audit committee and remuneration committee.
- ▲ Role of the chief executive officer.
- ▲ Leadership.

Monitoring and control

- ▲ Systems of control.
- ▲ Decision-making process and decision-making capability of the board.
- ▲ Reports from management to the board.
- ▲ Board's monitoring of activities reported to it.
- ▲ Status, role and scope of the internal audit function.
- ▲ Role and function of the external auditors.

Remuneration and related areas

- ▲ Remuneration, including share incentives, of executive and non-executive directors.
- ▲ Incentive schemes for staff.
- ▲ Related-party lending, conflicts of interest and related matters.

Disclosure

- ▲ Disclosure to stakeholders.

The committee conducted interviews with all persons performing executive and non-executive functions in the five banking groups, as well as the groups' external auditors and the risk officers of the banks in the groups. The committee expected to present its report and findings to the Registrar of Banks during the first quarter of 2003.

It has become clear in recent years that, in the interests of good corporate governance, legislation, regulation, policy and guidelines in the different sectors of the financial-services industry need to be brought in line with each other. Therefore, the Financial Services Board and the Bank Supervision Department have embarked on a process of devising a common approach to the level of legislative implementation of a corporate-governance framework in the financial-services industry.

process of devising a common approach

HUMAN-RESOURCE PLAN

In previous annual reports, it was reported that the focus of the Bank Supervision Department's employment plan was to accord with the aim of promoting equity through diversity, in line with the 2005 human-resource (HR) plan of the South African Reserve Bank. In order to increase capacity, the Governor approved an organisational restructuring of the Department, and implementation thereof began during the year under review.

main aims are to promote employment equity and to ensure a competent and motivated workforce

In essence, the main aims of the 2005 HR plan are to promote employment equity in the Reserve Bank and to ensure a competent and motivated workforce. The policy, as implemented, includes the accelerated development and promotion of employees with potential from the designated group, that is, blacks (including coloured and Asian persons), females and disabled persons.

During the first seven months of 2002, the Department made good progress towards bringing the profile of its workforce in line with both the requirements of the 2005 HR plan and new developments in banking supervision. At the end of July 2002, 50 per cent of the Department's workforce was black, and males and females constituted 51 per cent and 49 per cent, respectively, of the workforce.

Department was particularly affected

In August 2002, however, the Reserve Bank embarked on an intense process of finding ways to contain costs, whilst achieving its employment-equity objectives. In order to contain the increase in costs and staff numbers, a moratorium was placed on all recruitment. The Bank Supervision Department was particularly affected, given its staff-turnover rate of 7 per cent, albeit an improvement on the rate of 10,2 per cent in 2001. By the end of 2002, the black component of the Department's workforce had decreased to the 2001 level of 49 per cent, whereas the composition in terms of gender remained at the July 2002 percentages.

initiatives

During 2002, the Department continued with the following initiatives:

- ▲ Fast tracking of employees from the designated group, and appointment of cadets. Three cadets (two from the designated group) were appointed.

- ▲ Training of bank supervisors from, amongst others, the member countries of the East and Southern Africa Banking Supervisors Group and of emerging auditing firms.
- ▲ Formulation of career plans for the various job clusters, such as analysts, information technologists and legal consultants.

ISSUES THAT WILL RECEIVE PARTICULAR ATTENTION DURING 2003

The issues on which the Bank Supervision Department will place particular focus during 2003 include the following, most of which are discussed elsewhere in this annual report:

focus areas

- ▲ Continued leadership of and participation in the Accord Implementation Forum in order to address and resolve issues pertaining to the implementation of the new Basel Capital Accord (Basel II), as well as interaction in this regard with other supervisors.
- ▲ Continued amendment of the regulatory framework and the supervisory process and procedures, as well as development of complementary tools, in order to cater for the requirements of Basel II.
- ▲ Finalisation of a regulatory framework to enable the establishment of second- and third-tier banking institutions aimed at providing broader access to finance.
- ▲ Ongoing review of the banking legislation to ensure that it remains in line with international and local developments and standards in addition to those required by Basel II.
- ▲ Development of a policy framework for banks' reporting in accordance with Accounting Standard AC 133 and assessment of the impact of AC 133 on statutory reporting.
- ▲ Interaction with the Accounting Standards Board on the transparency and fair-value accounting requirements of Accounting Standard AC 133, and continued interaction with the accounting profession through the Auditor-regulator College discussed in the previous annual report.
- ▲ Promotion of more diversified shareholding structures and stability of large shareholders of banks in furtherance of the stability of the banking sector.
- ▲ Participation in the finalisation of the proposed financial charter for South Africa, in order to ensure that the stability of the financial sector is not impaired.
- ▲ Continued monitoring and surveillance of banks' liquidity positions, as well as trading activities and positions.
- ▲ Continued on-site review of banks' risk-management processes and practices.
- ▲ Ongoing combating and investigation of illegal deposit-taking institutions, and measures to create investor awareness.
- ▲ Assessment and monitoring of banks' implementation of anti-money-laundering measures, as well as their compliance with the relevant local legislation and international requirements.
- ▲ Continued participation in the initiatives and activities of international and regional bank-supervisory bodies, such as the Basel Committee on Banking Supervision and the East and Southern Africa Banking Supervisors Group.

A WORD OF THANKS

Once again, I wish to express my appreciation to the Minister and Deputy Minister of Finance for their valued inputs to requests in terms of statutory requirements. Sincere thanks also go to the Governor and Deputy Governors of the South African Reserve Bank, in particular to Ms Gill Marcus, both as Chairperson of the Policy Board for Financial Services and Regulation and as the Department's Deputy Governor, for their continued cooperation, guidance and support, which my staff and I have found to be invaluable. We further wish to thank the many local and international organisations, as well as individuals, whose cooperation the Department again received during the past year - to list but a few, the Chief Executive of the Financial Services Board and his staff, the senior executives of banking institutions and their external auditors, The Banking Council South Africa, the Standing Committee for the Revision of the Banks Act, 1990, the auditing profession, the staff of the South African Reserve Bank, the East and Southern Africa Banking Supervisors Group, the Basel Committee on Banking Supervision and the central bankers and bank supervisors worldwide with whom the Department liaises on an ongoing basis.

The above review gives but a small taste of the difficulties that faced the Department during a very stressful year for the South African banking system. As the focus areas for 2003 and subsequent chapters indicate, the challenges that the future holds for bank supervisors promise to be no less demanding. I, therefore, wish to express my sincere gratitude to my staff for continuing to handle their ever more difficult task and substantial workload with professionalism, dedication and enthusiasm.

C F Wiese

Registrar of Banks, and General Manager: Bank Supervision Department